Life Assurance Policies

Summary

1. Some life assurance policies are not taken out as a means of purely providing life insurance (for this subject, please see the Research Notes in the Protection section). Both regular and single premium life assurance policies are often marketed as investment products. Such regular premium life assurance policies are often called ‘endowments’, and such single premium life assurance policies are usually marketed as ‘investment bonds’. This is not to be confused with the asset class of fixed interest investment into corporate or government bonds.

2. Life assurance policies with an investment content are structured as an insurance wrapper, within which collective investment funds are usually held - e.g. unit-linked with profits funds, investment funds and structured (‘guaranteed’) funds. The tax treatment of this wrapper both internally and on the investor differs markedly from the treatment in place for direct investments into such holdings.

3. The suitability of a life assurance policy will depend upon the quality and choice of investment funds offered within the policy, the taxation of the policy compared to the individual’s own tax position, and the level of charges incurred under the policy. The additional product wrapper involved in an insurance bond often means an additional layer of charges.

4. The current capital gains tax regime means that more suitable options can often be found outside the insurance policy arena, e.g. direct holdings in collective investment funds such as unit trusts or OEICs. In addition, life assurance policies can be inflexible and high charging, offering particularly poor value if surrendered in the early years.

5. There are, however, situations where life assurance policies can meet investors’ needs, and specialist advice must be taken. For example, an investment bond may be considered for an investor who regularly crystallises capital gains in excess of their CGT annual exemption, and who may be a lower rate tax payer (or even a non-UK resident) at the time of future withdrawals above the 5% level allowed.

6. An ISA investment should always be considered as a preference, as a tax-advantaged investment wrapper. Please see our Research Note on ISAs for further details.

Types of Life Assurance Policy

Life assurance policies are generally split into two main types, qualifying and non-qualifying, which affect how they are subject to tax in the hands of the investor.

Qualifying Policies

These are generally policies that have regular level premiums payable at least annually, and for at least ten years, and no charge to tax usually arises at maturity or on a death claim. If the policy is surrendered or made paid up within ten years (or three-quarters of the term if sooner), then a chargeable gain could arise. New policies from 5 April 2013 can only be written in single ownership to be eligible for qualifying status. The qualifying rules are more complicated than this, however, and individual situations should be discussed with a financial adviser or the life office. These types of policies generally include policies such as endowments and some whole of life policies. Qualifying policies taken out prior to 14 March 1984, and unaltered since then, may still be eligible for Life Assurance Premium Relief.

Please note that new policies (or existing policies where benefits are extended) from 21 March 2012 have an additional limit on the level of annual contributions that can be made in order to be a qualifying policy of £3,600 (affecting premiums paid after 5 April 2013). The limit will be applied to all policies which are beneficially owned by an individual; part owners will be deemed to be full owners. Where a policy is assigned after 5 April 2013, it will lose its qualifying status, unless as a result of a divorce settlement, court order, between spouses or into trust.
Non-Qualifying Policies

These are generally single premium policies, generally taken out for investment rather than life cover reasons (although they will, as life policies, contain some minimal element of life cover, typically 1% or 0.1% of the value). These types of policies are often called investment bonds (although bear no relation to investment in corporate bonds), but can also include certain types of whole of life policy.

Onshore Life Fund Taxation

Irrespective of whether a policy is qualifying or non-qualifying, the taxation treatment of the fund within the policy wrapper is the same. The taxation of life insurance companies is complicated, however, in relation to the life insurance funds, the company is subject to tax at 20% on interest income, property rental income and overseas dividend income, with UK equity dividends exempt. Capital gains are taxed at 20%, after indexation allowance. The company is able to offset management expenses against the investment income for tax purposes.

These taxes are paid directly by the insurance company and cannot be reclaimed by the policyholder. Life assurance funds will therefore not generally be suitable for non tax payers. Basic rate taxpayers benefit from a 20% tax credit when gains are triggered, which is generally higher than the effective tax rate paid by the fund manager.

Compared to an equivalent collective investment vehicle such as a unit trust, where no tax is charged on internal capital gains, the life assurance fund will therefore generally grow at a lower rate over the long term. A more detailed comparison is attached in the Appendix to this Research Note.

Personal Taxation

No liability to personal taxation will usually arise on a qualifying policy, although please note the comments above regarding the taxation paid within the life assurance fund and early surrenders; also the low maximum contribution limit from April 2013. The generally high charges on these contracts can also mean that the tax benefits are largely reduced.

On a non-qualifying policy, a liability to personal taxation may occur if all of the following conditions are met:

- A chargeable event occurs - including death, maturity, surrender, part-surrenders above the 5% limit (see below), assignment for money or monies worth, and on some policy loans.

- A chargeable gain arises - confusingly, any gain is actually taxed to income tax, not capital gains tax. No relief is available for losses except in some limited situations where a loss has been made overall when the policy is terminated, but gains have previously arisen on partial surrenders.

- If the gain, when added to the investor’s total income in that year, falls within the higher or additional rate tax brackets, the gain is taxed at the higher rate less the deemed internal life fund taxation rate of 20%, giving a net charge of up to 25%. ‘Top slicing’ relief, calculated according to the number of years the policy has been held, is available for basic rate tax payers where the gain brings them into the higher or additional rate tax brackets.

5% Withdrawals

Under present legislation the policyholder is able to withdraw up to 5% of the initial investment each year for up to 20 years, with no immediate charge to tax. If no 5% withdrawal is made one year, the allowance rolls forward into future years. This defers the tax payable until the policy matures (or another chargeable event occurs), which can be useful for those who are currently higher rate taxpayers, but believe they will become basic rate taxpayers in the future, for example in retirement, or who believe they may become non-UK resident in the future. This facility could be withdrawn in the future.
**Gifting Life Assurance Policies**

A life policy can be gifted to another person or a trust, and no income tax charge will arise on the gift provided this is made for no consideration. For non-qualifying arrangements, the income tax on any eventual profits will depend upon the identity of the recipient:

1) An outright gift of the policy to an adult recipient - any future gains are assessed on the recipient.
2) An outright gift of the policy to a minor - any future gains would be assessable on the new owner. However the minor cannot usually surrender the policy, so no gains will arise until the owner is an adult, at which time any gains will be assessed on the owner as above.
3) Policies held in trust, where the settlor is alive and UK resident in the tax year in which the gain arises - the profits will be taxed in the hands of the settlor, who can then recover the tax, where possible, from the trustees.
4) Policies held in trust, where the settlor is dead or non-UK resident in the tax year in which the gain arises, and one or more of the trustees is UK resident - the profits will be taxed in the hands of the trustees, at the applicable trust rates. This tax cannot be reclaimed by the beneficiaries, even if they are basic rate taxpayers. If the trustees are not resident in the UK, any UK beneficiary receiving benefit from the gain will be taxed at their own tax rates, and not eligible for top slicing relief.
5) An exception to the above rules on trusts is that that where a policy is held on absolute trusts for an adult beneficiary or beneficiaries, the trust is ignored and the beneficiary /beneficiaries assessed.

Single premium bonds can usually be constructed with multiple lives assured so that may be no chargeable event until the last of the lives assured. If you consider a situation of a 60 year old parent establishing a bond in trust with 20 year old children who have a life expectancy of 80 and beyond it is clear that a chargeable event can be avoided for a very long time - until the last of the children dies.

The use of a suitable trust assists this process. The trustees can make distributions to beneficiaries, often using the 5% tax deferred annual facility. For distributions in excess of 5%, tax will be due at the trust rate on the chargeable event amount, or if the bonds are part assigned to beneficiaries who then surrender them, tax will be at the beneficiaries' tax rates. In the case of younger beneficiaries in their 20s, the tax rate may then be nil if the bond is onshore and 20% if offshore - assuming they are basic rate taxpayers. Due to the flexibility of the offshore bond this structure is often combined with a trust to assist with Inheritance Tax Planning.

**Offshore Life Assurance Policies**

The principle differences between onshore and offshore bonds will be in terms of tax treatment (see below) and investor compensation. Although most offshore financial centres have financial compensation schemes equivalent to the UK, the actual level of regulation may not be as robust as in the UK.

The main form of offshore life assurance policy sold is the single premium investment bond. As the bond does not suffer UK tax (although may be subject to withholding taxes on dividends received), there is no internal tax to offset. Investor’s liability to income tax on a chargeable event is therefore charged at their full marginal rate, i.e. 45% for an additional rate taxpayer, 40% for a higher rate taxpayer or 20% for a basic rate taxpayer. However, management expenses cannot be offset against income for tax purposes, as with onshore bonds - this is one of the reasons that offshore bond charges tend to be higher than onshore bond charges.

Please note that the taxation of offshore life assurance policies is currently under review by the Revenue, and any tax changes may affect policies in existence at the time of the change as well as policies taken out from the date of the change.
Charges

Initial

With any insurance product it is worth remembering that the initial and to an extent recurring annual costs are determined by the level of commission that the adviser/salesman takes from the insurance company, which can be up to 6% or more of the premium invested. Therefore, an investment of say £500,000 into a single premium bond could deliver £30,000 to a commission-based adviser. This commission has to be paid for somehow and the insurance company will either:

- Levy an initial charge of the commission amount, e.g. 6% meaning that your investment into the bonds is worth 6% less immediately, or
- Levy an increased annual charge (e.g. 1.5%) each year for the first 4-5 years together with a severe early exit penalty to ensure that they are protected if you encash your bond before they have clawed back the commission.

If the adviser charges you a fee and does not take commission then the charges are likely to be far more reasonable. clarity are fee based advisers, and do not take initial commission unless specifically requested to offset fees. This means we can generally arrange contracts without an initial charge and without additional annual charges or early termination fees.

Annual

Annual fees for providing the insurance contract vary significantly from company to company and to a great extent depend on the amount invested. For higher investment amounts, typically over £500,000, it is possible to negotiate lower annual fees. Typically you would expect to pay between 0.5% - 1% p.a. up to investments of £500,000 and between 0.25% - 0.5% p.a. for investments over £500,000. If your adviser asks the insurance company for annual commission then this is added on to the fee.

In all cases you will also suffer the annual management charge of the underlying funds that you invest in, likely to be 0.5%-1.5% pa. However, you would pay these charges even if you invested directly in the funds without the life assurance wrapper.

Comparison with Non-Life Assurance Funds

It is helpful to contrast the tax treatment of non-qualifying onshore and offshore policies (investment bonds) with the tax treatment of the underlying funds as if they were purchased and held directly by the investor. This is summarised in the Appendix below. Please note that this is intended to cover the main aspects only, and is not intended to be exhaustive.
**Appendix - Comparison of Tax Situation of Investment Vehicles**

<table>
<thead>
<tr>
<th>Taxation Within the Wrapper</th>
<th>Onshore Investment Bond</th>
<th>Offshore Investment Bond</th>
<th>Unit Trusts (including OEICs/ICVCs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax</td>
<td>Insurance company funds are subject to tax at 20% on interest, rental income and overseas dividend income. UK dividend income is exempt. The company is able to offset the management expenses against the investment income.</td>
<td>No income tax is charged on income within the investment bond. UK dividend income is exempt. However, irrecoverable withholding tax may be suffered.</td>
<td>Income, in the form of interest, rent or from overseas dividends, received by the Unit Trust is subject to Corporation Tax at 20%. UK dividend income is exempt. The company is able to offset management expenses and interest paid against taxable income.</td>
</tr>
<tr>
<td>Capital Gains Tax</td>
<td>Capital gains within the fund are taxed at 20%</td>
<td>No capital gains tax is charged on capital gains realised within the bond.</td>
<td>Internal capital gains within an authorised Unit Trust are exempt from tax.</td>
</tr>
</tbody>
</table>

**Taxation on the Individual**

| Crystallisation of Tax | Withdrawals within 5% limits can be made without immediate charge to tax. Chargeable gains on withdrawals above these limits are subject to income tax. There is therefore some scope to defer crystallising gains until a tax year where income is at a lower marginal rate, or when non-UK resident (5 year rule applies). Switching between funds within a bond does not trigger a chargeable event. | The holder is assessable to income tax on income and dividends as they are received by the fund manager, regardless of whether they are distributed. Capital gains are taxed on sale. There is therefore some scope to defer crystallising gains until a tax year where income is at a lower marginal rate, or when non-UK resident (5 year rule applies). Switching between funds will trigger a chargeable gain/loss. |

<p>| Position on Death | A chargeable event will be triggered on death of the life assured (or last surviving life assured) as for any other chargeable event, and income tax may be chargeable in addition to inheritance tax if the life assured was the owner of the policy. However, if the bond is written into trust, then the value may not fall into the settlor’s estate for inheritance tax purposes. | No capital gains tax applies on death, and value is uplifted to current value for beneficiaries. Inheritance tax may apply. |</p>
<table>
<thead>
<tr>
<th></th>
<th>Onshore Investment Bond</th>
<th>Offshore Investment Bond</th>
<th>Unit Trusts (including OEICs/ICVCs)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital Gains Tax</strong></td>
<td>All chargeable gains are subject to income tax, therefore no opportunity to use CGT annual exemption or offset capital losses.</td>
<td>Capital gains on disposal subject to capital gains tax, with annual exemption and offset of capital losses available to reduce the gain. Transfers can also be made between husband and wife to take advantage of both individual’s allowances and tax rates.</td>
<td></td>
</tr>
<tr>
<td><strong>Income Tax</strong></td>
<td>All chargeable gains are subject to income tax. The savings rate tax band and personal savings allowance can be used, if available.</td>
<td>Income payments from non-equity Unit Trusts are paid gross from 2017, and taxed as interest, with the savings rate tax band and personal savings allowance available to be used against this. Dividends are paid gross and taxed to dividend rates, with the dividend allowance available for the first £2,000 of income.</td>
<td></td>
</tr>
<tr>
<td><strong>Tax Status</strong></td>
<td>No further tax liability on any gains (unless chargeable gains push income into the higher rate tax bands in which case top slicing relief available). Tax deducted at source on the underlying fund cannot be reclaimed.</td>
<td>Income tax is payable on the chargeable gain at applicable rate(s) only if the gain takes the investor beyond the savings rate tax band and personal savings allowance (£1,000 for non-tax payers). Top-slicing relief may be available if the gain takes the investor into the higher rate brackets. Withholding tax suffered is not reclaimable.</td>
<td>No further tax liability and all interest/dividends received gross in any case. Any gain will be subject to capital gains tax.</td>
</tr>
<tr>
<td><strong>Basic rate tax payer</strong></td>
<td>No further tax liability on any gains (unless chargeable gains push income into the higher rate tax band, in which case top slicing relief is available). Tax deducted at source on the underlying fund cannot be reclaimed.</td>
<td>Chargeable gain taxed at basic rate of income tax (20%), after taking account of any savings rate tax band and personal savings allowance (£1,000 for basic rate taxpayers). Top-slicing relief may be available if the gain takes the investor into the higher rate bracket. Withholding tax suffered is not reclaimable, therefore overall rate of tax suffered may be higher than basic rate.</td>
<td>Tax payable at 20% for interest income (above applicable savings rate tax band and personal savings allowance of £1,000) and 7.5% for dividends (above dividend allowance of £2,000). Any gain will be subject to capital gains tax.</td>
</tr>
<tr>
<td>Higher rate tax payer</td>
<td>Onshore Investment Bond</td>
<td>Offshore Investment Bond</td>
<td>Unit Trusts (including OEICs/ICVCs)</td>
</tr>
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<tr>
<td>Any chargeable gain will be subject to the difference between basic rate (20%) and higher rate (40%) income tax, i.e. at a further 20% on the net gain. Overall rate of tax may therefore be less than 40%, depending upon the life company’s marginal rate of tax.</td>
<td>Chargeable gain taxed at higher rate of income tax (40%) after taking account of any savings rate tax band and personal savings allowance (£500 for higher rate taxpayers). Withholding tax suffered is not reclaimable, therefore overall rate of tax suffered may be higher than 40%.</td>
<td>Tax payable at 40% for interest income (above applicable savings rate tax band and personal savings allowance of £500) and 32.5% for dividends (above dividend allowance of £2,000). Any gain will be subject to capital gains tax.</td>
<td></td>
</tr>
<tr>
<td>Additional rate tax payer</td>
<td>Any chargeable gain will be subject to the difference between basic rate (20%) and additional rate (45%) income tax, i.e. at a further 25% on the net gain. Overall rate of tax may therefore be less than 45%, depending upon the life company’s marginal rate of tax.</td>
<td>Chargeable gain taxed at additional rate of income tax (45%) after taking account of any savings rate tax band. No personal savings allowance available. Withholding tax suffered is not reclaimable, therefore overall rate of tax suffered may be higher than 45%.</td>
<td>Tax payable at 45% for interest income (above applicable savings rate tax band, with no personal savings allowance available) and 38.1% for dividends (above dividend allowance of £2,000). Any gain will be subject to capital gains tax.</td>
</tr>
</tbody>
</table>

**Tax Returns**

Investment bonds are non-income producing assets. Details of the bond do not have to be included until a chargeable event is triggered, and at such time the relevant details must be included in the Self Assessment return. For those liable to file Self Assessment returns, income and capital gains usually need to be declared.
<table>
<thead>
<tr>
<th>Residency</th>
<th>Onshore Investment Bond</th>
<th>Offshore Investment Bond</th>
<th>Unit Trusts (including OEICs/ICVCs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors who become resident outside the UK (NB UK tax position only – local tax may also be charged depending on county of residency)</td>
<td>No change to taxation of underlying investments within bond – funds continue to be subject to UK taxation. No UK tax is charged on chargeable gains realised whilst the investor is non-UK resident (although tax suffered on the underlying fund cannot be reclaimed), unless period of non-residency does not exceed five complete tax years, in which case the gain becomes subject to income tax on return to the UK.</td>
<td>No change to taxation of underlying investments within bond – non-reclaimable withholding tax continues to be suffered on some dividend income. No UK tax is charged on chargeable gains realised whilst the investor is non-UK resident, unless period of non-residency does not exceed five complete tax years, in which case the gain becomes subject to income tax on return to the UK.</td>
<td>No change to taxation within Unit Trust. On individual, dividend and interest income not subject to further UK tax. Capital gains tax is only charged on gains which are realised in non-UK residency on assets acquired when UK resident, where period of non-residency does not exceed five complete tax years (i.e. gains become chargeable to UK tax when become resident again during this time).</td>
</tr>
<tr>
<td>Investors who return to the UK after living abroad</td>
<td>Onshore investments are still subject to UK taxation rules. Time apportionment relief available for new or assigned policies after 5 April 2013.</td>
<td>Time apportionment relief available - may reduce tax liability on any gains or reduce a loss, e.g. if an investor lived outside the UK for 3 years of a 10 year investment, only 70% of the gain is taxable. Topslicing relief is not available for the years of non-residency.</td>
<td>Investments are still subject to UK taxation rules. If period of residency outside the UK has exceeded five complete tax years, base cost of holdings can be ‘rebased’ by sale and reinvestment prior to return to UK residency.</td>
</tr>
</tbody>
</table>

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested.

Our views are based upon our understanding of current legislation in England & Wales. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances. You should not act on any of the information without seeking professional advice.

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